Urban Local Governments Need a Share in the GST

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Cities are often recognised as engines of economic growth. It is estimated that they contribute over 50 per cent of national output. With India aspiring to become a 'developed' economy by 2047, cities will need to play an important role in supporting the required economic growth. This will be possible only with strong city governments.

However, the current situation in India is of "rich cities, poor city governments". Urban Local Bodies (ULBs) in India do not receive an adequate share of tax resources despite economic prosperity emerging from these cities. The Ministry of Housing and Urban Affairs (MoHUA)'s average annual expenditure over the last 10 years was estimated to be only ₹0.5 lakh crore, which is less than one-fifth of the estimated minimum investment requirement. This large gap in available resources has resulted in poor infrastructure development, limited improvements in service quality, and a worsening resilience of cities to meet the challenges of water shortages and contamination, as well as traffic and flooding. The recent introduction of Goods and Services Tax (GST) in India has probably made cities even poorer. This is of concern as India already has poor performance in global comparison with regard to intergovernmental transfers (IGTs).

Introduction of GST and Impact on Local Revenues

In 2017, Goods and Services Tax (GST) was introduced in India. This has had a further adverse impact on the municipality's own revenues. Thus, the need to increase IGTs is even more important now.

In addition to the low level of IGTs in India, even local taxes have been affected by the GST. Globally, cities levy business taxes. Similarly, the state of Maharashtra had a local business tax for cities. However, with GST, a few local taxes have also been abolished. It has further affected some key local sources such as Entry tax (octroi), Local Business Tax (LBT), Advertisement tax and Entertainment tax.

The impact of GST on local finances is well illustrated for Mumbai. Jha (2019) and Udas-Mankikar (2018) estimate that "In compliance with the new GST regime, the Municipal Corporation of Greater Mumbai (MCGM) has had to abolish octroi, which on average had contributed almost 35 per cent of its annual total revenue" (p. 2). Maharashtra, which is the only state that promised a share of GST to urban local bodies (ULBs) in place of octroi and local body taxes, the state government has not regularly transferred this promised share.

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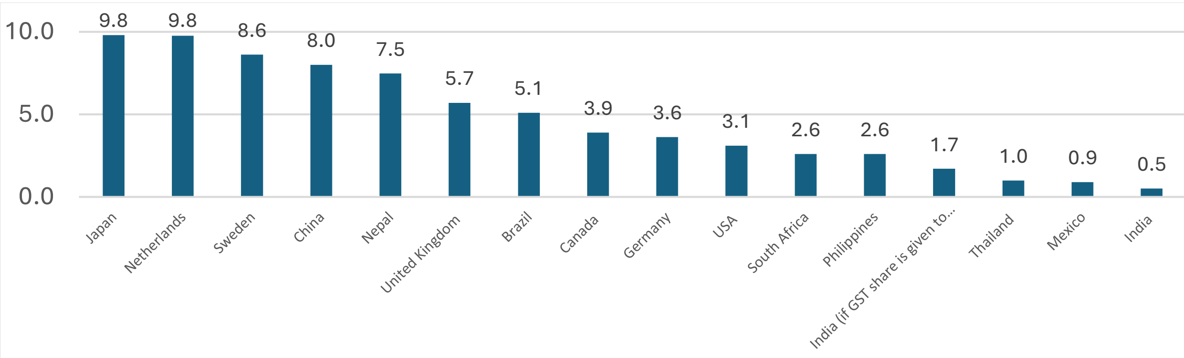
Inter-Governmental Transfers – International Comparison

One of the key sources of income for urban governments worldwide is inter-governmental transfers (IGTs). The Figure below shows that compared to other countries globally, the share of IGTs as a % of GDP is low at only 0.45% in India (Ahluwalia et.al. 2019, p.11). For example, in Mexico, it was 1.6%; in South Africa and the Philippines, 2.5%, and in Brazil, 5.1%. Particularly, the example of the Philippines is noteworthy. As per its Local Government Code, the Government of the Philippines allocates 40 per cent of its internal revenue income as transfers to local governments. In addition, under this code, the local governments are also authorised to mobilise debt from banks and financial institutions (Marzan, 2011).

IGT as a percentage of GDP



Sources: For Netherlands, Sweden, UK, Canada, Germany and Mexico: OECD (2022); for Japan: OECD (2021); for Brazil: OECD (2016); for South Africa: OECD (2016 c); for USA: Bureau of Economic Analysis (2020); for China: Yongzheng Liu (2019) p. 10; for Nepal: Intergovernmental fiscal transfers in a federal Nepal (2021); for Philippines: Diokno-Sicat, J. (2019) p.8; for Thailand: Statista Research Dept (2020); for India: ICRIER-State of Municipal Finances (2019), p.62, 63, 99, Ministry of Statistics & Programme Implementation (2026).

As against this, estimates for 2024-25 suggest that ULBs in India received IGTs of INR 1.3 lakh crore. Of this, nearly 25 per cent is through major urban development scheme grants such as AMRUT, SBM and Smart Cities. This includes both central and state grants for these schemes to local governments. In India, a share of funding under Centrally Sponsored Schemes does not flow directly to ULBs but is routed through state parastatals or special purpose vehicles (SPVs). Such expenditures are therefore not reflected in the estimates of transfers to ULBs. In addition to these transfers, an estimated INR 1 lakh crore was also transferred from the Central and State Finance Commissions to ULBs.

Compared to other developing countries such as South Africa and the Philippines, where IGTs to ULBs were over 2.5% of GDP, the level of IGTs to ULBs in India has remained largely unchanged between 2017 and 2024 at around 0.5% of GDP. This suggests a need to reconsider the IGT framework in India and the extent of funding accruing to ULBs.

Need for a "Fixed" share of GST for the Third Tier

Thus, it is critical to ensure that ULBs receive a share of GST to make the level of IGTs in India comparable to other countries. This will also help incentivise them to promote economic growth and play an important role in the vision of "Viksit Bharat".

In the past, both political stalwarts and learned academicians have argued for a share of the GST for the third tier. Ahluwalia et al. (2019) suggested that "the long-term solution to correct for the structural fiscal imbalance", which has crept into the system following the GST-related Constitutional amendments in 2016. It may be necessary to explore amending the Constitution again to provide for the sharing of the revenues from the GST among all three levels of government. Prof. Vijay Kelkar also highlighted the vertical imbalance in India's federalist structure and advocated for a share of GST resources for the Third Tier by allocating "1/6th of GST revenues for the Third Tier" (Kelkar, 2019).

Expert advice on this issue was also provided by the Indian Council for Research on International Economic Relations (ICRIER) team in its report (Ahluwalia et al., 2019). It mentioned that "Municipal finances have been the worst hit by this structural reform". It further suggests, "to maintain fiscal balance across the three levels of government, the combined revenues from GST ought to have been shared among all three levels of government. Instead, the sharing has been half and half between the centre and states, and, in the process, the independent power of local governments to raise their own sources of revenue has been appropriated by the centre and states. GST has subsumed local taxes such as octroi, including accounts-based octroi, in the form of local body tax, entry tax and advertisement tax." (p. 11). More recently, to address these issues, the Urban Development Ministry had also "asked for a specific share of revenues from the GST for ULBs" (Economic Times, 2020).

In 2024-25, the net GST collection was Rs. 19.5 Lakh crores. Thus, the allocation for ULBs, as suggested by many scholars as a 1/6th share of GST with the third tier of Government, and an equal sharing between rural and urban local bodies, would be only Rs. 1.6 lakh crore per annum for ULBs. While this will nearly double the current level of IGTs to ULBs, the ratio of IGTs to GDP will still increase only to 0.5.

Local Body Finances List in the Constitution of India

In addition to this enhanced funding, the status of local governments in our Constitution needs to be strengthened. Many scholars have also argued for including a separate list of revenue sources for local governments in the Constitution. It is pointed out that while the 74th Constitutional Amendment Act (CAA) suggested a list of functions for urban local governments under the 12th Schedule, it did not provide a municipal resources list to match the functions. They have to depend on state governments to allocate such resources from the state list. Unfortunately, the State Finance Commissions (SFCs), which were charged with this, have also not been very successful in most states. The Fifteenth Finance Commission (XV FC) also strongly recognised that, despite constitutional backing, SFCs have remained the weakest link in India's fiscal federal framework, resulting in inadequate, delayed, and discretionary transfers to local bodies.

It was in this background that the High Powered Empowered Committee (HPEC) in 2009 had recommended "an appropriate amendment of the Constitution/other measures to insert a 'Local Bodies Finance List' (LBFL) along the lines of the Union and State Lists" (p. 129). Though this issue has been discussed frequently in the past. However, it now requires urgent and priority attention, especially in light of the impact of the Goods and Services Tax (GST).

In this context, the Government of India needs to revise Schedule 7 of the Constitution of India, granting fiscal powers to the local government and transferring an adequate share of the resources.

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